Standardisation from a Law and Economics Perspective

8. Standardisation from a Law and Economics Perspective

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1. INTRODUCTION

The goal of this chapter is to examine standardisation from a law and economics perspective. More particularly, it will focus on the role of private standard-setting and evaluate its potential advantages and disadvantages from an economic perspective. Attention will also be paid to the effects of standardisation and to the question of whether, within a federal system, harmonisation of standards is required from an economic perspective.

This chapter will not engage with the legal debate concerning the role of standardisation in regulation or case law; many other scholars have done so,[1] including in various other contributions to this volume.[2] However, we do argue that the economic perspective provided in this chapter can certainly contribute to the European debate on standardisation. For example, in the legal debate, questions arise concerning the legitimacy of standardisation (an issue also addressed in this volume). Legitimacy is an issue that is not directly addressed in the economic literature. The reasons for this are twofold: first, legitimacy is not an economic notion; second, it is a strongly normative concept. Still, if a particular definition of legitimacy is provided, economists can make clear how, through the use of particular instruments, this concept of legitimacy could be promoted. In this way, the economic literature can contribute to the legal debate.

The structure of this chapter is as follows. Section 2 discusses the definition of the concept of 'standards' from a law and economics perspective. Focusing the discussion on private standards, Section 3 then provides an analysis of the social costs and benefits of such standards. Taking efficiency as the main cri-

[1] Harm Schepel, 'The New Approach to the New Approach: The Juridification of Harmonised Standards in EU Law' (2013) Maastricht Journal of European and Comparative Law 20(4): 521–33.

[2] See for example Chapter 3 and Chapter 7 in this volume.

terion, economic theory allows us to look at how the introduction of standards (positively or negatively) affects, for example, information costs, transaction costs, administrative costs and competition. One conclusion from this section is that private standards are not always the best instrument to address an externality or information problem. We will also discuss how legitimacy fits into the economic framework, *inter alia* by explaining how increased transparency and public participation may lower information costs and social costs associated with lobbying by industry. We argue that potential problems of output legitimacy could be addressed by increasing countervailing power to strong industry lobbying groups, if reputational concerns are not sufficient for this purpose. A case by case approach is thus required. Moreover, we stress that making private standard-setting more accountable or legitimate will be at the expense of certain advantages of private standards in terms of flexibility and costs. Subsequently, Section 4 focuses on the question of whether standardisation necessarily implies harmonisation. Based on the 'economics of federalism' theory, we conclude that harmonisation is not self-evident, as it may have advantages as well as disadvantages. Section 5 addresses the important question of whether it is possible to enjoy the benefits of standardisation without (most of its) disadvantages, by considering hybrid forms of regulation and competition between standard-setting bodies and by discussing the idea of also applying the criteria of Article 101(3) TFEU to an analysis of regulatory instruments such as standardisation. Section 6 concludes.

2. STANDARDISATION: AN ECONOMIC FRAMEWORK

Standards are traditionally viewed in economic theory as part of regulation, that is, an intervention by the legislator to remedy a market failure (Section 2.1). Various instruments could be used to remedy such a market failure (Section 2.2), whereby standards can be seen as the result of an economic process of cost–benefit weighing (Section 2.3). The literature generally distinguishes between various types of standards (Section 2.4), whereas standardisation is also possible via private regulation, so-called private standard-setting (Section 2.5).

Before starting this section, it should be mentioned that the concept of standards is in some economic literature also used to distinguish it from rules: rules would be very precise obligations imposed by a regulator leaving little discretion to regulated parties; standards would rather focus on the result, be described in vaguer terms (often via case law) and leave more freedom to the

industry as to how to achieve the particular result.[3] It is important to note that the standards we are referring to in this contribution do not necessarily fit into the definition of standards within this 'rules versus standards' debate, because what in the latter debate is referred to as a rule could for the purposes of this chapter equally be a standard.

2.1 Economic Argument for Regulation: Market Failure

Welfare economics teaches that, if particular conditions are met, more particularly the existence of a general equilibrium in an economy with perfect competition in all markets, the resulting allocation will be Pareto efficient.[4] However, these conditions will never be completely satisfied. There are market failures or market distortions. Regulation, in other words an intervention by law, is seen as a possible remedy for those market failures, aiming to lead to an increase in social welfare. Standards can be part of the legal remedy to market failure. Four basic types of market failure are distinguished in the literature:[5]

(Negative) externalities: Externalities arise if the activities of one subject cause (external) costs to another subject. For example, a factory discharging wastewater into the surface waters might cause negative externalities to users downstream.[6]

Information deficiencies: A second possible reason for regulation is that markets may not function optimally if there is a lack of information or even information asymmetry. Consumers particularly may lack information on the quality of services offered by professionals, while professionals may have this information, but lack the ability or willingness to communicate this to consumers. The Nobel Prize winner Akerlof showed that asymmetric information can lead to the process of adverse selection,[7] which in the end may lead to quality

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[3] See Louis Kaplow, 'Rules versus Standards: An Economic Analysis' (1992) Duke Law Journal 42: 557–629 and Franziska Weber, 'European Integration Assessed in the Light of the "Rules vs Standards Debate"' (2013) European Journal of Law and Economics 35(2): 187–210.

[4] Niels J Philipsen, *Regulation Of and By Pharmacists in the Netherlands and Belgium: An Economic Approach* (Intersentia 2003) 10–11.

[5] We merely present those classic market failures briefly for the purposes of this chapter; for a more extensive analysis see Philipsen, above n. 4, 12–19 and Robert Cooter and Tom Ulen, *Law and Economics*, 6th ed. (Pearson Education International 2012) 38–42.

[6] Positive externalities could also constitute a problem, but can be disregarded for the purposes of this chapter.

[7] Adverse selection refers specifically to the phenomenon where buyers of a product or service are not able to recognise the quality offered by producers, as a result of which they will not be willing to pay higher prices for better quality prod-

deterioration and an unravelling of markets.[8] Also, an information advantage may be abused, leading to moral hazard.[9] Regulation in the sense of law can be an answer to information deficiencies.

Lack of competition: A third classic market failure consists of market power or, more generally, all types of distortions in the functioning of the market mechanism. The best known are the abuse of a dominant position or cartel formation. Again, the lack of competition may lead to a loss of social welfare which regulation (more particularly competition law) should remedy.

Underprovision of public goods: A fourth form of market failure is the existence of so-called public goods.[10] A public good has two characteristics: non-rivalrous consumption and non-excludability. The first implies that consumption of the good by one person is not at the expense of another; the second means that it is either impossible or too expensive to exclude people from consuming the good. Classic examples of public goods are national defence, lighthouses and dykes. Precisely since others may not be excluded, the market will insufficiently generate those public goods. It relates to the so-called free-rider problem. Again, regulation should intervene (to increase social welfare) to guarantee a sufficient provision of public goods.

These four types of market failure are generally advanced as the so-called public interest arguments for regulation. Note that regulation in this economic literature generally refers to any intervention from the legal system to remedy the market failure. Regulation in this broad sense therefore not only refers to formal statutes or other public regulation issued by the government, but could also refer to private regulation.[11] As will be shown below, standards prescribing a particular behaviour can appear in all kinds of legal instruments. Note that standards are often introduced to address particular types of market failure. For example, environmental standards prescribing emission limit values for wastewater could address an externality problem; standards for professionals (such as architects, accountants or lawyers) could address information asym-

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ucts or services. As a result of this information asymmetry only products of average or low quality will appear on the market. That is why this is referred to as the 'market for lemons' in the famous article by Akerlof.

[8] George A Akerlof, 'The Market for Lemons: Quality, Uncertainty and the Market Mechanism' (1970) Quarterly Journal of Economics 84(3): 488–500.

[9] Niels J Philipsen, 'Regulation of Liberal Professions and Competition Policy: Developments in the EU and China' (2009) Journal of Competition Law & Economics 6(2): 206.

[10] Anthony Ogus, *Regulation: Legal Form and Economic Theory* (Clarendon Press 1994) 33–5.

[11] It should be noted that other instruments, such as liability rules and taxation, can be alternatives to regulation for solving a particular market failure. See Section 2.2 below.

metry. At the same time, the mere fact of introducing standards may also have the consequence that it creates (or increases) another market failure, more particularly a restriction of competition. For example, if standards for accountants prescribe a particular behaviour, that may reduce the possibility of competition between those professionals. One of the crucial questions, therefore, is whether it is possible to use standards in such a way that they do remedy particular market failures (such as externalities or information asymmetry) without disproportionately causing other market failures (such as restricting competition). That requires a balancing test verifying *inter alia* whether the standards are proportional to the market failure to be solved and whether they still leave sufficient room for competition between the market participants.

2.2 Instrument Choice

There is a range of options available to cure market failures. The question of which instrument should be used for which particular market failure and under what conditions has been addressed in the instrument choice literature, part of which is economic,[12] but important contributions are also provided by socio-legal scholars.[13] That literature points at a wide variety of possible instruments:

Rules of private law, such as civil liability: Under a regime of civil liability, courts can compel tortfeasors to compensate victims by selecting specific rules (negligence, strict liability and so on). Liability rules do not prescribe any particular standard of behaviour, but force the tortfeasor to compensate the harm that was caused. The idea is that this would provide incentives to take optimal care.

Public regulation – 'command and control': This consists of an administrative system based on licences, permits and standard-setting by administrative agencies. Public regulation determines what the regulated community has to do. In other words, standards are determined ex ante and will be enforced with public (administrative or criminal) sanctions in case of non-compliance.

Market-based instruments: Another approach, already advocated in the 1920s by Pigou, is the use of financial instruments to internalise externalities. These instruments are often referred to as 'incentive-based', 'market-based' or 'economic' instruments. The basic idea of those mechanisms is to correct an externality by returning an appropriate fee or cost to the potential wrongdoer.

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[12] For example Steven Shavell, 'Liability for Harm versus Regulation of Safety' (1984) The Journal of Legal Studies 13(2): 357–74.

[13] See in this respect especially the seminal book by Neil Gunningham and Peter Grabosky, *Smart Regulation: Designing Environmental Policy* (Clarendon Press 1998).

Most commonly implemented are the Pigouvian taxes, but there is in fact a range of options including subsidies for desired behaviour and emission trading systems.

Suasive mechanisms: Beyond public regulation and market-based mechanisms another option has emerged – that of 'nudging' the regulated industry in a particular direction. This can be achieved by use of so-called 'defaults' in compliance efforts or by educational or informational publication campaigns.

Private regulation: Finally, an alternative to command and control regulation is that standards would be developed by non-government private actors. Those standards could be developed by the regulated industry itself (which is generally qualified as self-regulation) or by other private parties (such as standardisation organisations). The latter is indicated as private standard-setting.

In fact, from an economic perspective, the standard, in the sense of the optimal mechanism to remedy the market failure, can be implemented via any of the abovementioned instruments. One important question which arises nowadays is which instrument is appropriate to cure which particular market failure and whether it is possible to design an optimal so-called smart combination (mix) of different instruments.[14]

2.3 What Are Standards?

The nature of the standard depends very much on the type of market failure to be cured. For example, if the market failure consists of a negative externality (such as pollution or traffic accidents) the standard in its simplest form consists in the result of a marginal cost/marginal benefit weighing leading to a behavioural standard, sometimes referred to as a standard of care. More specifically, the marginal cost of additional preventive efforts (for example, more expensive pollution abatement equipment) would be weighed against the marginal benefits in reducing the likelihood of an accident (or environmental harm). The result of this balancing process is the definition of an optimal care standard, that is, the point where the marginal cost of prevention equals the marginal benefits in the reduction of the probability of the accident.[15] Such a (theoretically optimal) standard can in principle be incorporated into any of the legal or policy instruments discussed in the previous subsection. Thus,

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[14] See in that respect *inter alia* Jonathan B Wiener, 'Global Environmental Regulation: Instrument Choice in Legal Context' (1999) The Yale Law Journal 108: 677–800 and Judith van Erp, Michael G Faure, André Nollkaemper and Niels J Philipsen (eds), *Smart Mixes in Relation to Transboundary Environmental Harm* (Cambridge University Press 2019).

[15] The seminal paper in this respect is Steven Shavell, 'Strict Liability versus Negligence' (1980) The Journal of Legal Studies 9(1): 1–25.

for example, the optimal care standard could relate to a due care standard in liability law, could be implemented via mandatory public regulation (such as a condition in a specific permit) or could be introduced as a tax which would apply for any behaviour in excess of the optimal care standard. In other words, from this perspective, standards are much broader than often defined in the legal literature and can in principle be found in any of the legal and policy instruments previously discussed.

2.4 Types of Standards

It is important to mention that the economic literature distinguishes between various types of standards.[16] A target standard prescribes no specific standard regarding the output, but imposes (criminal) liability for certain harmful consequences arising from the output. Target standards focus on a prohibited consequence and leave it to the undertaking to determine the cheapest means of avoiding that consequence.[17]

A second type of standard is referred to as a performance (or output) standard. This requires certain conditions of quality to be met at the point of supply (for example, emission levels), but leaves the supplier free to choose how to meet those conditions.[18] An example of a performance standard would be an emission limit value with which the undertaking has to comply regarding the wastewater emitted into the surface waters: the performance standard is monitored and liability rises if the standard is not met. The way to reach that particular standard can still be determined by the undertaking.

A third type of standard is a specification (or input) standard. That compels an undertaking to employ particular production methods or materials and is therefore highly interventionist.[19] The major disadvantages of those specification standards is that they may lack any incentive for innovation: undertakings will only have to comply with the specified technology and have no incentives to further invest in research and development. Moreover, specification standards (requiring the use of one particular technology) can be highly anticompetitive.[20] The specification standard is an example of a remedy for a particular market failure (a negative externality) which may cause another market failure (restrictions on competition).

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16 More particularly Ogus, above n. 10, 150–79 and Philipsen, above n. 4, 29–32.
17 Ogus, above n. 10, 166.
18 Ogus, above n. 10, 151.
19 Ibid.
20 Ogus, above n. 10, 167–8.

2.5 Private Standard-setting

The legal debate concerning standardisation (and also many contributions to this volume) equate standardisation with private standard-setting. As was made clear in the previous sections, however, from an economic perspective, standardisation refers more generally to a variety of instruments that can be used to cure market failures. Private standards would fit into private regulation. Private regulation refers to standard-setting by non-governmental private entities. In particular cases, private regulation can be self-regulation. This refers to the case where the standards are set by the regulated industry itself. In this case we focus on private standard-setting, that is, on standards set by private entities (such as standardisation organisations) but not by the regulated community itself.

Before focusing more closely on the costs and benefits of private standard-setting in the next section, it is from the outset important to stress that one lesson from the economic literature is that private standards are only one possible way of curing market failures. If it would appear that the costs of private standard-setting outweigh the advantages, it remains important to recall that (as stressed in Section 2.2) there are many other legal and policy instruments that could be used as an alternative to private standards.

3. COSTS AND BENEFITS OF PRIVATE STANDARD-SETTING

The law and economics literature has pointed to particular advantages and disadvantages of private standard-setting.[21]

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[21] See *inter alia* Anthony Ogus, 'Self-regulation' in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopedia of Law and Economics* (Edward Elgar 2000) 587–602; Roger Van den Bergh, 'Towards Efficient Self-Regulation in Markets for Professional Services' in Claus-Dieter Ehlermann and Isabela Atanasiu (eds), *European Competition Law Annual 2004: The Relationship between Competition Law and the (Liberal) Professions* (Hart Publishing 2006) 155–76; Roger Van den Bergh, 'De maatschappelijke wenselijkheid van gedragscodes vanuit rechtseconomisch perspectief' (2008) Weekblad voor Privaatreecht, Notariaat en Registratie 139: 792–8, and Niels J Philipsen, 'Professional Licensing and Self-Regulation in Europe and China: A Law and Economics Perspective' in Michael Faure and Xinzhu Zhang (eds), *Competition Policy and Regulation: Recent Developments in China, the US and Europe* (Edward Elgar 2011) 205–37; Niels J Philipsen, 'The Role of Private Actors in Preventing Work-Related Risks: A Law and Economics Perspective' (2018) European Public Law 24(3): 539–53.

The main arguments presented in the literature will be reviewed here, as these arguments might provide an important contribution to the current debate in the legal literature on private standards.

3.1 Potential Advantages

There are several advantages identified in the law and economics literature. It should be noted that some of the literature deals generally with private regulation, without distinguishing between private standard-setting and self-regulation. Some arguments may play out differently in the case of private standards rather than self-regulation. Traditional advantages of private standard-setting might be:

- Lower information costs. Private standard-setters often have greater expertise and technical knowledge, which could reduce information costs for creating the standards (as compared to standard-setting by the government).[22]
- Private standard-setting can also be more flexible than public regulation. Private standard-setting does not have the disadvantages of a bureaucracy and therefore has greater flexibility. This implies that private standards can be more easily adapted to changing circumstances. Potentially, private standards are therefore more dynamic than public regulation. Private standard-setting may also have the advantage that there is not the danger (as with public regulation) that standards are created that limit consumer choice or restrict innovation.[23] The assumption in the literature is that, under private standard-setting, there may be better incentives for the standard-setter to create flexible differentiated standards which can dynamically follow, for example, evolutions in technology. Whether that assumption always holds is of course an empirical issue.
- Another advantage of private standards is that normally the administrative and compliance costs are lower. The creation of private standards will often be paid by the regulated community and will thus not negatively affect the public budget, being paid not by taxpayers, but rather by the consumers of the services or products.[24]

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[22] Ogus, above n. 10, 97–8; Van den Bergh, above n. 21, 7; Philipsen, above n. 21, 544–5.

[23] Ogus, above n. 10, 98; Van den Bergh, above n. 21, 8; Philipsen, above n. 21, 545.

[24] Ibid.

3.2 Potential Disadvantages

Economists also see potential disadvantages in private regulation. Those disadvantages are not only economic in nature, but sometimes refer to arguments presented by lawyers as well.[25]

Private standards may be the result of capturing of the standard-setting entity (even when it is a private entity). In cases where standards are purchased by the regulated community, the private standard-setters are in a dependent relationship with that regulated community. That relationship creates the suspicion that private standard-setters may not always have an interest in creating optimal standards. Reputational mechanisms may drive private standard-setters towards the creation of optimal standards, but it is not always clear if that reputational mechanism is sufficiently strong to incentivise private standard-setters towards optimal standard-setting.[26]

This danger of inefficient standard-setting can result in inefficiently low technical standards or inefficiently high technical standards. The danger of low technical standards arises especially in cases where no prior technical standards (private or public) exist. Compliance with high technical standards would then create high costs for industry, which might therefore lobby the private standard-setter for (too) low technical standards. However, in some cases frontrunners in industry (with informational advantages) may lobby for precisely the reverse: very high technical standards. *De facto* frontrunners in industry can already comply with those stricter standards. Raising them to (semi-compulsory) obligations via private standard-setting would have the advantage of creating barriers to market entry for competitors. This is the well-known phenomenon of 'trading up', whereby frontrunners in industry lobby for severe (public or private) standards to create barriers to market entry.[27]

Private standard-setting may more generally result in anticompetitive behaviour. In some cases, the mere fact that private standards are created could amount to an agreement between industry to follow particular standards, thus restricting competition in the market.[28] Compare in that respect the argument against specification standards (see Section 2.4) as being anticompetitive. This

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[25] For a summary of these arguments see Willem H van Boom, Michael G Faure, Nick JH Huls and Niels J Philipsen, *Handelspraktijken, reclame en zelfregulering* (Boom Juridische uitgevers 2009) 31–2.

[26] See generally Philipsen, above n. 4 and Philipsen, above n. 21, referring also to the public choice literature.

[27] See generally David Vogel, *Trading Up: Consumer and Environmental Regulation in a Global Economy* (Harvard University Press 1997).

[28] See Ogus, above n. 10, 99 and Van den Bergh, above n. 21, 8.

problem could be avoided if there were sufficient competition between different private standard-setters. However, in many cases the number of private standard-setters is very limited or *de facto* even restricted to one supplier of private standards. Moreover, if there is competition between private standards, there is the danger that private standard-setters will not compete with higher (that is, closer to the optimum) standards, but rather by offering standards that please the regulated community. If there is no remedy for that type of destructive competition, adverse selection may occur,[29] as a result of which only those private standard-setters that please the regulated community would survive in the market.

Furthermore, the abovementioned advantage of private standards as being more flexible has a flipside, namely that flexibility possibly comes at the cost of less secure and precise procedures.[30] Private standards can be created more easily and at a lower cost, for example, because they do not have to take into account requirements of democratic accountability (inherent in public regulation), transparency or public participation. This may make the creation of standards more flexible, cheaper and easier, but obviously has disadvantages for the contents of the standards. The lack of transparency, public participation and democratic accountability mechanisms also imply that the already mentioned danger of takeover of the private standards by the regulated community becomes even more serious as there is no countervailing power against industry lobbying.

A final disadvantage of private standard-setting is that usually private standard-setting organisations create standards, but are not always involved in enforcement. In some cases other private institutions (such as certification societies) may verify compliance with the private standards, but generally compliance and enforcement remain a weak point of private standard-setting.[31]

3.3 Legitimacy and Accountability

Having addressed some potential advantages and disadvantages of private standard-setting, it has become clear that some of the arguments advanced in legal literature can also be understood from an economic perspective. Lawyers often criticise private standards for lacking legitimacy and democratic control.[32] The worries expressed by lawyers concerning the private character of

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[29] Akerlof, above n. 8.
[30] Philipsen, above n. 21, 545.
[31] Van Boom et al, above n. 25.
[32] See for example Linda Senden, 'Smart Public–Private Complementarities in the Transnational Regulatory and Enforcement Space' in Judith van Erp, Michael G Faure, André Nollkaemper and Niels J Philipsen (eds), *Smart Mixes in Relation*

the standards (and the lack of democratic control and transparency) can also be understood from an economic perspective. In his famous work on the logic of collective action, Mancur Olson indicated that lobbying by private interest groups will largely be successful if two conditions are fulfilled:[33]

Low transaction costs for the lobby group: The group should be 'single-issue oriented' and well organised. Small groups with clearly defined goals have a relatively large likelihood of being successful in lobbying, as the costs of organising the group and agreeing on a particular strategy will be low.

High information costs for the public at large: Lobbying will result in so-called rent seeking by the interest group.[34] This means that the special interest group will get particular benefits (rents) as a result of the lobbying to the disadvantage of the public at large. An important condition for successful lobbying is that the public at large does not discover that rent seeking is taking place. If private standards are formulated in an atmosphere of secrecy behind the veil of professionalism and confidentiality without transparency, accountability or public participation, private standards are more likely to serve the interests of industry rather than the interests of the public at large. Public choice theory predicts that these features increase the likelihood of inefficient standard-setting.

Public choice theory may equally provide a remedy: if transparency is increased and accountability mechanisms are introduced, the costs of lobbying increase and the likelihood that private standards are made only in the interests of industry decrease. Mechanisms such as transparency, accountability and public participation can in economic terms reduce information costs for the public at large and therefore increase the quality of private standard-setting. Arguments for increasing public participation in standard-setting can be found in the work of Nobel Prize winner Gary Becker. Unlike the abovementioned public choice school (Buchanan, Olson), Becker presented a theory of competition between interest groups for political power.[35] Becker holds that if

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to Transboundary Environmental Harm (Cambridge University Press 2019) 25–48 and Fabrizio Cafaggi, A Comparative Analysis of Transnational Private Regulation: Legitimacy, Quality, Effectiveness and Enforcement, EUI Working Paper LAW 2014/15 (2014).

[33] Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Harvard University Press 1971). Note that Olson's criteria for successful collective action of course refer to lobbying at the level of the government; the criteria may, however, also explain the relative success of interest groups in capturing private standard-setting agencies.

[34] See James Buchanan, Robert Tollison and Gordon Tullock, *Toward a Theory of the Rent-Seeking Society* (A&M University 1980).

[35] Gary S Becker, 'A Theory of Competition among Pressure Groups for Political Influence' (1983) Quarterly Journal of Economics 98: 371–400. See also Philipsen, above n. 4, 26.

various interest groups representing different interests compete for political influence, the comparative process that results should not necessarily lead to inefficiency. A normative conclusion from this insight is that it is important to organise a countervailing power against the interests of industry in the private standard-setting process. Allowing effective participation by, for example, NGOs or civil society in the private standard-setting process decreases the risk of capturing by industry.[36] In this case, private standard-setting could become more a Becker-like comparative process where countervailing interests also provide input to guarantee that private standards are set in the public interest.

Finally, it is important to stress that the lack of transparency and accountability in the private standard-setting mechanism will not automatically lead to inefficient standards. In some cases, the market and reputational controls can be so strong that corporate actors will themselves strive for the imposition of optimal standards. Food safety can provide an example. Large supermarket chains which are globally active are very sensitive to food scandals, which they want to avoid at all costs. As a result, these large chains often rely on private standard-setting when, for example, products are purchased on the international market (in Asia or Africa). Those large commercial chains will contract certification societies to verify (via a variety of different monitoring techniques) whether the products they wish to buy correspond to the private standards. Even though this type of private standard-setting too has been the subject of criticism (again from the perspective of lacking accountability, control and legitimacy)[37] and even though private standards and certification may not be able to prevent all food safety risks,[38] it could be argued that in this particular case the lack of transparency and accountability concerning the creation of the private standards should not necessarily lead to inefficient standards. On the contrary, large chains can suffer larger reputational losses from an outbreak of a food crisis and will therefore have powerful incentives to enforce high private standards on their contracting partners. Moreover, those contracting partners wishing to export to Europe and to be able to contract with those large chains will also have powerful incentives to comply with

[36] The problem may arise that NGOs could participate in the standardisation process, but that they may not be able to effectively influence the process because they do not have the means to compete with the power of the industry. In that sense mere participation may not be sufficient: it has to be an *effective* participation.

[37] See for example Elena Fagoto, *Industry Food Safety Standards: Public and Private Interest in Food Safety*, PhD dissertation, Erasmus University Rotterdam (2015).

[38] See further Michael Faure, 'The Economics of Harmonization of Food Law in the EU' in Harry Bremmers and Kai Purnhagen (eds), *Regulating and Managing Food Safety in the EU: A Legal-Economic Perspective* (Springer 2018) 263–90.

the imposed standards. The only problem that may arise is that in some cases small producers, more particularly in developing countries, may not be able to comply with the high (private or public) standards imposed by importing countries in the developed world.[39] However, from the perspective of the consumers in the developed world in the north in that particular case, the lack of transparency and accountability may not be a problem. In that case reputational and market mechanisms will provide sufficient guarantees for enacting and enforcing optimal standards. But again: those incentives resulting from market pressures may be present with large chains who have a reputation at stake, but might not be present with smaller sellers. The latter may especially be a problem with occasional producers, so-called rogue traders who would engage in a 'hit and run' strategy. To them the fear of a reputational loss may not be a serious deterrent.

This example shows that the desirability of private standard-setting should probably be differentiated depending upon the particular risks and cases, related *inter alia* to the question of whether the market actors concerned still have sufficient interests (as a result of reputational and market pressures) to comply with high (private) standards. If the latter is the case then the lack of transparency and accountability in private standard-setting should not necessarily lead to a decrease of social welfare and they are therefore, at least from an economic perspective, not necessarily problematic.

3.4 Criteria for Private Standard-setting?

As the various chapters in this volume make clear, private standard-setting is now widely used in almost all areas where market failures need to be controlled. We provided examples from food safety, professional services (accountants, lawyers, architects) and environmental standards. But private standard-setting also appears in airline security,[40] and even in nuclear safety, where the World Association of Nuclear Operators (WANO) plays an important role.

Given the previous subsections in which potential advantages and disadvantages of private standards were presented, the question arises as to whether it would be possible to identify domains where the use of private standard-setting would be appropriate and domains where it would be less appropriate. Considering the domains where private standard-setting plays a role today, one could argue that private standards may work well in domains where market

[39] See, for a detailed account of the difficulties experienced by shrimp producers in Benin wishing to export to the EU, Kévine Kindji-Gaspard, *Market Access Issues in International Food Trade: Shrimp Exports from Benin to the EU*, PhD dissertation, Maastricht University (2015).

[40] Senden, above n. 32.

forces and reputational mechanisms still play an important role (such as with food safety). In those cases the advantages of private standard-setting might outweigh the disadvantages. In other domains, such as nuclear safety, private standard-setting may be less obviously beneficial and an argument could be made for a more restricted role for private standards.

It remains important, however, to keep in mind alternatives to private standard-setting. One way of dealing with the disadvantages of private standard-setting would be to improve the alternatives (public regulation, private law or market-based instruments). An obvious alternative to private standard-setting would be to make public regulation more flexible, more dynamic and thus closer to the beneficial features of private standard-setting.[41]

While analysing the choice between licensing and certification in relation to services, Shapiro argued that several criteria are relevant.[42] More specifically, the choice depends *inter alia* on the heterogeneity of consumer preferences, the relationship between human capital and quality, the presence of reputational effects and the marginal costs of providing high quality. It may be possible to develop similar criteria related to the choice between private standard-setting and its alternatives.

An important lesson from the discussion of the potential disadvantages of private standard-setting (addressed in Section 3.2) is that some of those problems (competition problems, a lack of sanctioning mechanisms and inefficiently low or high standards) could be addressed by specific remedies. Competition problems could, for example, be addressed by using private standard-setting only when there are more private standard-setters available in the market who compete on quality and where adverse selection can be avoided. The lack of sanctioning mechanisms could be dealt with, for example, by reporting obligations (obliging the regulated community to report on their compliance with the private standards), by using private or public certifiers who monitor compliance with the private standards and by having public authorities verifying compliance with private standards as well. The danger of inefficiently low or high standards could be remedied by introducing the transparency and accountability mechanisms discussed in Section 3.3 and by allowing for public participation in the standard-setting process, thus providing for a countervailing power. Those remedies could improve the likelihood that private standards are also set in the public interest.

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[41] See also Philipsen, above n. 21, 547–8.

[42] See Carl Shapiro, 'Premiums for High-Quality Products as Rents to Reputation' (1983) Quarterly Journal of Economics 98(4): 659–80; Carl Shapiro, 'Investment, Moral Hazard and Occupational Licensing' (1986) Review of Economic Studies 53(5): 843–62.

4. HARMONISATION?

Another question that is widely debated in the legal domain is whether private standards should be harmonised at EU level or can be differentiated at Member State level. Again, law and economics have developed particular criteria, which might prove interesting to review.

4.1 Economics of Federalism Perspective

The economic literature with respect to externalities has taken as a starting point, following the seminal work of Tiebout,[43] that competition between legal orders has the advantage that regulation and standards will be provided that best correspond to the preferences of citizens.[44] The starting point is therefore that decentralisation has the advantage of providing standards that match in an optimal way the local preferences of citizens. Regulatory competition increases the quality of regulation and the existence of various regulatory regimes moreover has the advantage of creating possibilities for mutual learning.[45] From that simple starting point, economists would argue that the mere existence of different private standards should as such not be considered problematic. On the contrary, given the large variety in market participants and local circumstances, there may be major benefits in having differentiated standards corresponding to differing preferences of citizens. Van den Bergh therefore argues that because the preferences of citizens (for example on food quality) may differ, the same may be seen with regulation (and private standards) among Member States.[46]

Centralisation may, however, be warranted when particular market failures exist. One market failure which was already mentioned is the danger of transboundary externalities. Again, the case of food safety standards could be illustrative: if the issue concerns not merely food quality but food safety, centralisation might be warranted. Negative externalities require a centralised response where the preferences of consumers are sufficiently homogeneous,

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[43] Charles M Tiebout, 'A Pure Theory of Local Expenditures' (1956) Journal of Political Economy 64(5): 416–24.

[44] See in this respect *inter alia* Wallace E Oates and Robert M Schwab, 'Economic Competition among Jurisdictions: Efficiency Enhancing or Distortion Inducing?' (1988) Journal of Public Economics 35(3): 333–54.

[45] Roger Van den Bergh, 'Towards an Institutional Legal Framework for Regulatory Competition in Europe' (2000) Kyklos 53: 435–66.

[46] Roger Van den Bergh, 'Farewell Utopia? Why the European Union Should Take the Economics of Federalism Seriously' (2016) Maastricht Journal of European and Comparative Law 23(6): 937–64.

'such as a general desire for food safety. In this way rules combating the BSE disease may be supported'.[47] That therefore means that if the use of private standards entails the risk of transboundary externalities (which is surely not always the case) there may be an argument for centralisation limited to this particular risk.

A second argument for centralisation relates to the danger of a race to the bottom. Usually competition between private standards would have beneficial effects and improve social welfare.[48] Only if there were empirical evidence that Member States would compete with each other via the creation of private standards that would be inefficiently low in order to attract industry would there be an argument for centralisation.[49] Again, whether a danger of a race to the bottom exists will very much depend upon the specific sector. It cannot generally be concluded that the mere existence of different private standards would necessarily lead to a race to the bottom. Again, that will all depend upon factual circumstances and therefore needs empirical support.

A final reason for centralisation would be the existence of economies of scale and transaction cost savings resulting from the harmonisation to one private standard.[50] The argument holds that the existence of different standards creates costs and that harmonising those differences to one standard would reduce those costs. This argument is obviously flawed, as it neglects the benefits of differentiation (standards being better adapted to the varying preferences of citizens). Moreover, the argument also wrongly assumes that the harmonisation of private standards would be a costless exercise.

Summarising, from the perspective of the economics of federalism, the mere existence of various private standards should not be a reason to call for harmonisation. That would only be warranted in the case of clear proof that private standards would lead to an externalisation of harm to other jurisdictions or if there were empirical evidence that private standards would be used in a race to the bottom. There is no a priori reason to believe that this would be the case.

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47 Van den Bergh, above n. 46, 951.

48 Richard L Revesz, 'Rehabilitating Interstate Competition: Rethinking the Race-for-the-bottom Rationale for Federal Environmental Regulation' (1992) New York University Law Review 67: 1210–54.

49 Michael G Faure, 'Harmonisation of Environmental Law and Market Integration: Harmonising for the Wrong Reasons?' [1998] European Environmental Law Review 171–2.

50 Faure, above n. 49, 173.

4.2 Internal Market Perspective

In addition to the economics of federalism there is another theoretical perspective to the question of harmonisation, which is the so-called internal market perspective. Many harmonisation efforts at EU level are based on the idea that harmonised rules would facilitate the free flow of persons, products, services and capital, or in other words that harmonised rules would promote the internal market.[51] The argument holds that private standards could create barriers to trade if different Member States were to apply different standards. Harmonising private standards would then be needed to support free trade. The problem with this argument is that, even if all private standards were (hypothetically) harmonised, this would not create a level playing field in the EU as differences in, for example, energy resources, access to raw materials and atmospheric conditions will still lead to differing marketing conditions that favour trade. In addition, there are examples of integrated markets (without distortions of trade) with a strong differentiation, for example of rules of private law. That is the case, for example, in the United States and Switzerland. Notwithstanding strong differences between rules of private law, there are no significant impediments to trade as a result of those differences. Empirical evidence also suggests that it is not because of differences in legal rules that consumers do not engage in cross-border trade, but rather as a result of other impediments (such as distance, language and so on).[52] The idea that the internal market would require a harmonisation of private standards can therefore not be supported by economic theory.

4.3 Policy Perspective

What follows from the previous discussion is that, within the EU legal debate, it may be too easily concluded that private standards need to be harmonised. From the economics of federalism perspective, it needs to be shown that differentiated standards actually create transboundary externalities or a race to the bottom, or lead to substantial transaction cost savings that exceed the costs of drafting and implementing EU law without overriding the preferences of citizens.

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[51] For a detailed analysis of these two different economic approaches to harmonisation, see Miriam C Buiten, *Harmonisation and the EU Internal Market: A Law and Economics Approach*, PhD dissertation, Erasmus University Rotterdam (2017).

[52] Kirsten Thommes, Michael G Faure and Klaus Heine, 'The Internal Market and the Consumer: What Consumers Actually Choose' (2014) The Columbia Journal of European Law 21(1): 47–70.

Moreover, it has also been stressed in law and economics literature that the internal market argument is only one side of the coin. Even if it could be shown that harmonised private standards were to facilitate trade, they still would have the major disadvantage of restricting competition. In the words of Ogus, 'In the light of the welfare losses arising from over-reaching differences in national preferences, full harmonisation may be undesirable, at least in some areas of regulation'.[53] The law and economics literature has indicated that in some domains (such as regulating foodstuffs), EU harmonisation has gone much too far, based on the internal market argument. Van den Bergh argues:

> However, many EU Directives look like recipes in a (poor quality) cook book. Examples include the rules on the composition of chocolate, jam and fruit juices. It may be doubted whether the best brains in Brussels should spend their precious time on fixing the amount of cocoa butter, vegetable feds and milk and chocolate, deciding the amount of sugar in fruit juices and nectars, defining tomato juice as fruit juice and determining the fruit content in jam, jellies and marmalade.[54]

He therefore concludes:

> Again, this does not imply that there is no need for EU legislation, but rules should be restricted to cases where the benefits of centralisation outweigh its disadvantages. The Directives on the composition of foodstuffs cannot be explained by welfare considerations, but rather as the result of a political compromise between pressure groups from industry and attempts to shelter the 'fortress Europe' from imports of Africa (palm oil).[55]

A few final comments in this respect: first, differentiated private standards do not necessarily endanger trade and even if that were the case, it does not necessarily call for harmonisation. Alternative remedies could be sought (less restrictive of competition), such as mutual recognition of different private standards.[56]

Second, recent literature has also indicated that the criteria for centralisation may (under restrictive conditions) point to a need for centralisation, but not necessarily harmonisation. That would imply that in some circumstances decisions could be shifted to the EU level, for example if there were transboundary externalities or evidence of a race to the bottom, but differentiated standards

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[53] Ogus, above n. 10, 176.

[54] Van den Bergh, above n. 46, 951.

[55] Ibid.

[56] On the remedy of mutual recognition and its advantages compared to harmonisation, see Wolfgang Kerber and Roger Van den Bergh, 'Mutual Recognition Revisited: Misunderstandings, Inconsistencies, and a Suggested Reinterpretation' (2008) Kyklos 61(3): 447–65.

(taking into account varying local preferences) could still be applied.[57] Moreover, recently the Ostrom model of polycentric governance has also been applied to the EU again pleading in favour of a multidimensional approach of competition between various layers of legislators and standard-setters.[58]

Third, the criteria of Article 101(3) TFEU could also be used to analyse regulatory instruments such as private standards.[59] This again implies that many remedies are possible to deal with some of the more problematic aspects of private standard-setting, but that those aspects do not necessarily lead to the need for harmonisation.

4.4 Improving Private Standard-setting?

The question arises whether it is possible to address the disadvantages of private standard-setting (mentioned in Section 3.2) and still enjoy some of its benefits (mentioned in Section 3.1).

A few remedies have already been suggested above (in Section 3.3) which might better guarantee that private standard-setting comes closer to the optimal standard. Some of these suggestions can now be combined.

A first possibility is to increase the costs of lobbying by private interest groups, thus reducing the risk of capturing of the private standard-setter. One way to do this is to improve the transparency of the private standard-setting process; another is to allow for a countervailing power in that private standard-setting process, for example by NGOs or civil society. Private standard-setting would then be made more accountable and comply with higher standards of transparency, also including public participation and democratic accountability. A problem, however, is that private standard-setting was introduced precisely because it was claimed to be more flexible, dynamic, cheaper and easier than public regulation since it is easier to formulate and adapt private standards. Adaptations to changing technology would for that reason be much easier with private standards, precisely because it is not hindered by the complicated decision-making procedures underlying public regulation. There is therefore an inherent risk that, when all the accountability and transparency guarantees (typical for public regulation) are also required

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[57] See in this respect Alessandra Arcuri, 'Controlling Environmental Risk in Europe: The Complementary Role of an EC Environmental Liability Regime' (2001) Tijdschrift voor Milieu en Recht 15(2): 37–45.

[58] Josephine van Zeben, 'Subsidiarity in European Environmental Law: A Competence Allocation Approach' (2014) Harvard Environmental Law 38: 415–64.

[59] See further Niels J Philipsen and Hans Maks, 'An Economic Analysis of the Regulation of Professions' in Evy Crals and Lode Vereeck (eds), *Regulation of Architects in Belgium and the Netherlands* (Lannoo Campus 2005) 11–45.

for private standard-setting, the costs of private standard-setting eventually become as high as the costs of public standard-setting. This is a danger in the tendency of 'democratising' private standard-setting, which is also indicated in the literature.[60]

A second solution is to envisage the creation of competition between different standards and different standard-setters. The problem has been addressed above. By avoiding a monopoly of one particular private standard-setter there could in theory be a better guarantee of optimal private standard-setting. This would also have the advantage that different types of private standards would emerge in the market whereby service and product providers could choose from different standards depending, *inter alia*, on the market in which they operate. However, the danger is always that when more private standards are created, this may lead to a race to the bottom towards the lowest standard. Precisely because industrial operators pay the private standard-setters, there may be a danger of adverse selection whereby in the end only inefficient standards appear on the market. Competition might entail the risk of a watering down of standards. The question also arises as to whom the specific standards are addressed. If the standards address industrial operators, they may well be able to choose standards which best fit their needs and preferences. However, if private standards are also meant as signalling instruments towards the end consumers, it is well known that increasing the amount of standards is not always beneficial for consumers' understanding. A large number of available standards might lead not only to watering down, but also to confusion among consumers, as happened *inter alia* with eco-labelling.[61]

A third possible solution would be to strive for particular forms of hybrid or co-regulation. That would imply that private standard-setting would still play a role, but would not be the sole instrument to control market failures. Private standard-setting would in that model be used in a smart mix with other instruments that could remedy the market failure (see Section 2.2). This could take several forms. One possibility would be so-called conditional self-regulation,[62] which basically entails that the government specifies under which types of conditions it will rely on self- (or private) regulation. There could be a government determination of the specific conditions under which private standard-setting would be accepted, whereby public enforcement could, for example, also play a role in monitoring compliance with the conditions of private standards. It would also be possible to combine public and private regulation, for example,

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[60] More particularly by Senden, above n. 32.

[61] On the law and economics of eco-labelling, see Alejandra Martinez Gandara, *The Law and Economics of Eco-Labels*, PhD dissertation, Erasmus University Rotterdam (2013).

[62] Van den Bergh, above n. 21, 156; Philipsen, above n. 21, 212.

through an accreditation by public authorities of particular private standards. That would imply that standards are still set privately, but that the government would control the quality of particular private standards and accredit the use of particular private standards that have been certified. The 'New Approach' to technical harmonisation and standards, as introduced in the EU in 1985, can be interpreted as one example of such a hybrid form of regulation. In the New Approach, all products and services that are in accordance with harmonised standards are presumed to conform to the 'essential requirements' defined in EU legislation; and public authorities must recognise these standards once they have been accepted.[63] Of course, defining the 'essential requirements' properly remains crucial, as are the criteria of transparency and competition (already indicated above) when setting the standards.

It may seem that it is virtually impossible to achieve the best of both worlds. Whatever solution is chosen, the inevitable consequence will usually be that the flexibility of private standard-setting is reduced and that costs increase as well. The crucial question therefore is if it is possible to introduce some public law elements into private standard-setting in a proportionate manner that makes it possible to enjoy the benefits of private standard-setting without the disadvantages. This is obviously a very difficult balancing act.

5. CONCLUSION

This chapter provided the economic perspective on standardisation generally and on private standard-setting in particular. It was made clear that in the legal debate standardisation now has a very specific connotation, but that standards in economic terms can in fact appear in a wide variety of legal and policy instruments. Basically, they are meant to be tools to remedy market failures. Optimal standards take into account cost–benefit weighing.

The economic literature also makes it clear that it is important to distinguish between various questions which sometimes become blurred in the legal debate. A first question is whether private standards are at all appropriate and can be considered the most efficient instrument (perhaps in an optimal mix with other instruments) to solve a prevailing market failure or to achieve another policy goal. Yet another question is whether an intervention at EU level with respect to private standard-setting is required. In that respect one should carefully distinguish whether the goal of such an intervention would be to cure a market failure (transboundary externality, race to the bottom, very high transaction costs) or to promote the internal market. Law and economics also teaches us that if the latter policy goal is chosen, it is important to verify

[63] See Chapter 1.

whether other (less intrusive or costly) measures than full harmonisation could equally provide a remedy and whether harmonisation can be considered a proportional remedy, also given the potential anticompetitive effects.

The law and economics literature pointed to several potential advantages of private standard-setting, but also to potential disadvantages. Many of those disadvantages can be reformulated as legitimacy problems in legal terms. What is discussed in the legal literature under the heading of legitimacy will appear in the law and economics literature as the danger of capturing by special interest groups.[64] A crucial question is whether eventually the actors concerned (the regulated community, but also the private standard-setters) still have sufficient incentives (also taking into account the payment structure) to safeguard the public interest rather than their private interests. In some cases, market and reputational mechanisms may guarantee that private and public interests align; at other times this might not be the case, as a result of which private standard-setting may be suboptimal.

In the latter case, a variety of remedies could be devised to make private standard-setting more legitimate. These remedies all relate to increasing the accountability of the private standard-setters, increasing transparency of the private standard-setting process and eventually even allowing public participation. Although including those public law elements into private standard-setting may undoubtedly have benefits, it will unavoidably come at the price of serious disadvantages in terms of flexibility and costs. If too strict conditions are imposed on private standard-setting, it is likely that all the benefits of private standard-setting will disappear as well.

[64] See in this respect *inter alia* Fritz W Scharpf, 'Economic Integration, Democracy and the Welfare State' (1997) Journal of European Public Policy 4(1): 18–36; Fritz W Scharpf, *Governing in Europe: Effective and Democratic?* (Oxford University Press 1999).